Congress of the United States
Washington, DC 20515

July 5, 2005

The Honorable Joseph T. Kelliher
Chairman
Federal Energy Regulatory Commission
888 First Street, NE
Washington, D.C. 20426

Dear Mr. Chairman:

As you know, ISO New England has asked FERC to approve a plan (called "LICAP" or "Locational Installed Capacity Proposal") to provide additional compensation to power plant owners/generators as an incentive for them to build power plants needed to insure adequate electricity supplies for New England in the future. We are writing you to express our opposition to this proposal, and to urge the Commission to reject it.

At the time that FERC adopted its landmark Order 888 to promote wholesale competition in electricity markets, the Commission ordered a functional unbundling of electricity generation and transmission services, while also noting that its order would accommodate a full corporate unbundling of generation and transmission – including divestiture of generation assets. The Commission's order appears to have been predicated upon an assumption and belief that opening up competition in generation by ensuring open and nondiscriminatory transmission access and approving market based rates for transmission would result in new competitors entering the generation market and resulting competition creating lower prices for consumers. In fact, FERC Order 888 indicated that:

> The Commission estimates the potential quantitative benefits from the Final Rule will be approximately $3.8 to $5.4 billion per year of cost savings, in addition to the non-quantifiable benefits that include better use of existing assets and institutions, new market mechanisms, technical innovation, and less rate distortion.

Today, New England has adequate supplies of electricity -- in fact, there is a surplus of generation that will last until the end of the decade. In the face of this surplus, the proposed LICAP rule, if approved by FERC, would result in the largest rate increase in the history of New England, effective January 1, 2006. In contrast to the type of competitive generation market that appeared to be envisioned by the Commission a decade ago, under the proposed LICAP rule, huge financial subsidies would be provided to generators based on complex regulatory formulas. It is hard for us to see how such an approach is consistent with the underlying philosophy behind wholesale competition in the generation market – competition which was supposedly going to move such generation from a regime in which vertically-integrated utilities received a regulated rate of return and consumers paid for investment in new generation, to one in which the costs and risks associated with new generation were to be shifted to generation company investors. Now, it appears that this cost is being shifted back to consumers in the form of LICAP charges.

Essentially, ISO-NE is asking FERC to order New England residential, commercial and industrial electric customers to pay out what some estimates have suggested could be $13.5 billion over the next 5 years to companies that own power plants in our region, in the hope that these power plant owners will be "incented" to build new power plants.

The consequences of this for New England electricity consumers could be serious. It has been estimated that the typical Boston area residential customer's electric bill would increase by a projected 21% - 24% over the next 5 years because of the LICAP payments that would go to power plant owners under the ISO's proposal. A similar 21%-24% increase is projected in Connecticut as well. Commercial and Industrial customers likely will also see very significant price increases. These rate increases to businesses in our region will have a devastating impact on our state's and our region's economy.

Because the LICAP payments are only "incentives," this money will go to generators without any requirement or commitment from them to build any power plants. It is therefore entirely possible that ratepayers could spend $13.5 billion for nothing.

We would note that the plan put forth by ISO is radical and experimental. There is no evidence that it will result in new generation in New England in the time frames needed. We also note that the ISO LICAP plan has broad opposition across New England. The ISO attempted but failed to achieve a 2/3rds vote of the NEPOOL Participants Committee for the first version of the LICAP plan, which ISO filed at FERC on March 1, 2004. ISO did not submit the current version of LICAP to the Participants Committee, and while ISO offered to continue a regional dialogue on LICAP, the FERC hearing schedule did not leave much of an opportunity to do so – particularly once the case was in litigation. All six New England governors are opposed to the LICAP proposal and have formally registered their concerns to the Commission. In addition, every state public utility commission in New England and the New England Conference of Public Utility Commissioners (NECPUC) has filed strong opposition to this plan at the FERC. The ISO LICAP Plan has also been broadly opposed by other New England market participants and stakeholders, including governors, state attorneys general, state consumer advocates, public utilities, municipal utilities, and investor-owned utilities.

A broad coalition of public officials and private parties tried to propose to FERC an alternative plan that that would be both much less costly and more certain to result in actual power plant construction since it would target payments to the type of generators needed for reliability and which had demonstrated that they were failing to earn sufficient revenues in the markets. Separate reliability option alternatives were put forth by the Connecticut Municipal Electrical Energy Cooperative and by a group led by the Connecticut DPUC. But the Commission refused to consider any alternatives other than the LICAP plan filed by ISO. The testimony and supporting evidence offered by the coalition, as well as similar testimony offered by other parties, were even stricken from the record of hearings at FERC.

On June 15, FERC Administrative Law Judge McCartney issued a recommended decision for FERC's approval. This recommended decision essentially endorses the ISO-NE LICAP plan, recommending no significant modifications to address the many objections and concerns raised by all the above listed parties.

In our view, there has been no showing that the LICAP mechanism approved by the Judge will result in just or reasonable rates. In evaluating the implications of ISO-NE's LICAP proposal, we respectfully request your assistance and cooperation in providing responses to the attached questions. We respectfully request that responses to these questions be provided to us as soon as possible.

We note that unless FERC rejects the ISO plan, this plan and its huge rate increases will become effective on January 1, 2006. We therefore urge the Commission to reject the ISO-NE LICAP plan, and to instead direct ISO-NE to go back and consult with all affected stakeholders to come up with alternative mechanisms for ensuring that our region's wholesale electricity markets function properly and that rates charged in such markets are just and reasonable and not unduly discriminatory or preferential – as is required under the Federal Power Act.

We look forward to receiving your response.

Sincerely,

Christopher Dodd
United States Senate

Edward J. Markey
Member of Congress

Jack Reed
United States Senate

Nancy L. Johnson
Member of Congress

Edward M. Kennedy
United States Senate

Christopher Shays
Member of Congress

John F. Kerry
United States Senate

Barney Frank
Member of Congress

Rob Simmons
Member of Congress

Rosa L. DeLauro
Member of Congress

James P. McGovern
Member of Congress

Richard E. Neal
Member of Congress

John W. Olver
Member of Congress

Martin T. Meehan
Member of Congress

Michael H. Michaud
Member of Congress

James M. Jeffords
United States Senate

Patrick J. Leahy
United States Senate

John F. Tierney
Member of Congress

Stephen F. Lynch
Member of Congress

Michael E. Capuano
Member of Congress

William D. Delahunt
Member of Congress

Bernard Sanders
Member of Congress

Patrick J. Kennedy
Member of Congress

John B. Larson
Member of Congress

Lincoln Chafee
United States Senate

Joe Lieberman
United States Senate

James R. Langevin
Member of Congress

Thomas H. Allen
Member of Congress

QUESTIONS FOR FERC REGARDING ISO-NEW ENGLAND LICAP PROPOSAL

1. Record evidence in the LICAP case before FERC indicates that the cost to customers during the first 5 years of this capacity payment plan could be as high as $13 billion. For the average residential customer in New England, approval of LICAP will result in rate increases in excess of 20% over the first 5 years. These payments will go directly to generators in order to "incent" them to build new power plants. Yet if generators do not build, LICAP has no penalty plan nor obligation on the generators to make refunds. Why should New England consumers pay existing generators the equivalent of the equity investment needed for more than 40,000 MWs of new generation with no guarantee the recipients will invest in new generation when needed? Why is there no ironclad obligation on the part of the generator-recipients of these payments to build new plants in exchange for these payments?

2. LICAP has been unequivocally opposed by every state public utility commission in New England, by the Governors of every state in New England, by the Attorneys General of Connecticut, Massachusetts and Rhode Island, by the Consumer Advocates of all the New England states, by the Massachusetts Department of Energy Resources, by consumer-owned power companies and the joint action agencies representing them, by the associations representing New England Commercial and Industrial customers, as well as by the major utilities in New England including NSTAR, Connecticut Light and Power Company, National Grid-USA, and Central Maine Power Company. In light of the unanimous view of every New England entity representing the public interest and every class of customer, why does FERC believe it is reasonable to impose LICAP on this region?

3. Is FERC aware of any support for LICAP by any party to this case except for the generators who would receive these windfall LICAP payments, the ISO, and the FERC Staff?

4. New England regulatory agencies, the entities that have the authority to design and implement resource adequacy requirements, are opposed to the demand curve LICAP proposal. This stands in sharp contrast to New York, a single state ISO, where the regulator developed the demand curve and has the jurisdictional authority to carry out the promises of such a program through its utility and siting policies. In PJM, another multi-state ISO, there is significant opposition to the demand curve proposal being vetted there. Why does FERC insist on implementing an incentive scheme where it lacks the authority to make it successful and the parties that have the authority are opposed to such a program?

5. In the New York LICAP case at the DC Circuit, FERC described LICAP in NY as an experimental rate[1] and asserted a right to deference for the court based on this experimental

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[1] *See New York Independent System Operator, Inc.*, 103 FERC ¶61,201 at P 17, *order on reh'g*, 105 FERC ¶61,108 at PP 20-21 (2003) ("NYISO's ICAP demand curve proposal is an innovative way to address the deficiencies in the existing ICAP market . . . . Whether this mechanism will produce an appropriate level of revenues to achieve its objectives cannot be known at this time.". . . ."Courts have held that the key to whether a rate is just and reasonable is the end result, not the particular formula used to reach that result." (citation omitted).

nature of LICAP. The NY ISO recently issued a report stating, "Finally, given the relatively brief history of the ICAP Demand Curves and the comparatively long lead time required to develop new generation, it is difficult to reach any specific conclusions regarding the effects of the Demand Curves on investment in new generation in New York." *New York Independent System Operator, Inc. Second Annual Compliance Report on the Implementation of ICAP Demand Curve and Withholding Behavior under the ICAP Demand Curve*, p. 1 (December 1, 2004). NY is the only place LICAP has been implemented. What is FERC's basis for concluding that the LICAP experiment in NY is or will be a success? What is the justification for extending this costly experiment to New England before there is definitive proof that the LICAP "experiment" has worked in New York?

6. Given that New England currently has excess generation and new transmission lines are to be constructed in the near future to relieve congestion, what problem is ISO-NE's LICAP scheme intended to remedy? At a minimum, would it not make more sense to await the completion of anticipated (within next 5 years) transmission improvements before implementing any kind of LICAP mechanism?

7. What alternatives to the LICAP demand curve were considered by ISO-NE prior to filing its original proposal with FERC? What alternatives were presented by ISO to FERC?

8. Why did FERC exclude the presentation and development of any alternatives to a LICAP demand curve during the proceedings?

9. What alternatives have been examined and rejected by FERC in other proceedings adopting a LICAP demand curve and what was the basis for rejection by the Commission?

10. Why is FERC favoring an administratively set price schedule over a capacity product purchased and sold in a competitive market?

11. If FERC believes that that the current capacity market does not pay generators sufficient money, that there are location-specific problem regions in New England that LICAP would help resolve, that location-specific price signals may encourage new generation in the right places, and that LICAP includes an administrative pricing mechanism that provides important protections against market power exercise that a pure competitive market approach likely would not have, doesn't this really raise some fundamental questions about the viability of FERC's overall vision of competitive wholesale electricity markets, as set forth in Order 888 and subsequent orders? If the future market structure is going to include wholesale electricity price caps on market prices, LICAP payments to generators, and higher incentive rates to transmission companies, how can FERC be confident that the resulting prices paid by consumers would be lower than those that would be afforded if market-based rates were denied and FERC returned to cost-based rate-of-return regulation?

12. LICAP is estimated to cost the average New England electricity customer an additional \$200/year—what tangible, quantifiable benefits will these payments buy and when will the payments be discontinued? What cost/benefit analysis supports the use of a demand curve

based LICAP scheme? Is LICAP being promoted as a "cost is no object scheme?" If not, where is the line drawn in the sand with respect to cost?

13. We are informed that the ISO did a cost/benefit study, but did not sponsor it as part of the evidence in the case. It was produced in January 2005, roughly 6 weeks before the hearing commenced. The study was presented to NECPUC and later introduced at trial as an exhibit (by NECPUC counsel). The study shows that LICAP "saves" money, if you assume that the alternative is that all generation in New England is under reliability must run (or "RMR") cost of service arrangements. Does FERC believe that such an assumption is appropriate, and if so, why? Does FERC plan to put every generator in New England or any other region under RMR contracts? If so, how would this be any different from cost of service regulation?

14. There currently is a 28% surplus of capacity in New England, projected to cover the region's needs until the end of the decade. What is the basis for accepting the LICAP scheme that would pay generators huge sums of money now to achieve a projected level of capacity that produces a reliability level where the probability of an outage is 1 day in 1,250 years--significantly in excess of the widely accepted NPCC standard of 1 day in 10 years? If the problem is that the surplus generation is not necessarily in the right places, shouldn't the focus be on alleviating inadequate transmission instead of providing generators with huge LICAP payments?

15 What jurisdiction does FERC have to mandate the purchase of capacity in excess of what state regulatory agencies require? Please cite any applicable statutes or orders granting FERC such jurisdiction.

16. What recourse do consumers have if LICAP is adopted and there is no new investment? Who should be held accountable? Should LICAP payments have to be refunded by the generators if they fail to make any new investment in generation in New England, or in demand side response programs that would avoid need for new generation?

17. Most of the New England states have adopted electric restructuring programs and the utilities they regulate have divested their generating units and terminated their long-term power contracts. One of the anticipated benefits of this process was the shift of the power plant investment risk from consumers to investors. How is the LICAP demand curve proposal consistent with the vision of a competitive wholesale market? If LICAP prices cause regulated load serving entities to enter into long term contracts for the construction of generators, will this have a positive or negative effect on retail restructuring? If FERC's believes that encouraging long-term contracts is desirable, are there other mechanisms that could encourage load-serving entities and generators to enter into such contracts?

18. FERC has indicated a disdain for cost of service RMR contracts because they distort the market. How is it that the LICAP mechanism that creates payments to all generators based on a hypothetical cost of service is not also considered by FERC to be a distortion of market forces?

19. What is the time interval for measuring the effectiveness of LICAP? For example, will an evaluation be made in 2 years? 3 years? When would a determination be made that LICAP does or does not work? What metrics will be used to measure the effectiveness of LICAP? If it is

determined that LICAP has not stimulated new investment, will it be eliminated or will more money be thrown at the "problem?"

20. The ISO predicts that LICAP obligations will be met almost entirely through bilateral contracts. However, to the extend that the administratively-set demand curve brings predictability, neither sellers nor buyers presumably will have an interest in bilateral contracts. Sellers would want to be paid no less than what they would be able to receive under the demand curve. Similarly, buyers will want to pay no more than what they would have to pay under the demand curve. Does FERC believe that LICAP obligations will be met largely through bilateral contracts, and if so, why?

21. One of the stated goals of LICAP is to reduce, eliminate or lessen the need for RMR contracts. How will the effectiveness of LICAP be measured against these goals? Can consumers expect to see *both* LICAP *and* RMR agreements? What role does the FERC see for RMR agreements post-LICAP? If there will be RMR contracts post-LICAP, what standards would FERC believe appropriate for cost-recovery under such contracts?

22. The original premise of the Devon case was to develop a solution to the problem that peaking units were not receiving sufficient compensation. LICAP, as proposed, would make payments to all generators—providing windfall profits to most generators, except peakers. How can this policy of payments to all generators be justified in a case designed to increase payments to peaking units only?

23. Is FERC aware of a process underway at NEPOOL to create a forward market for operating reserves that will address the need for peaking resources in constrained areas? Why hasn't FERC considered this type of market mechanism as a solution to the issues raised in Devon?

24. How do you respond to studies showing that certain units in New England (i.e., coal and nuclear), which would receive LICAP payments under ISO's proposal, already are recovering in excess of their cost of service plus a reasonable rate of return without LICAP?
Why should these entities be eligible to receive LICAP payments?

26. What is the appropriate standard, under the Federal Power Act, for assessing the LICAP rates?

27. Is FERC familiar with the stakeholder process underway in PJM? Does FERC understand that PJM has not filed a LICAP plan with FERC because it cannot get the vote of its stakeholders to file a section 205? Is FERC aware that PJM, unlike ISO-NE, has fully engaged its stakeholders in a several month long discussion of the problems those stakeholders see with LICAP, including an invitation by the PJM Board to those opposing LICAP to appear at the May 3rd board meeting to present their reasons for opposition? Is FERC aware that PJM opponents of LICAP are currently engaged in extensive work to develop an alternative to LICAP, the current version of which is posted on PJM website and does not include a demand curve?

28. Is FERC aware of the recent ELCON Report, "PROBLEMS IN THE ORGANIZED MARKETS," April 18, 2005? Is FERC aware that that ELCON is highly critical of LICAP type capacity schemes saying:

"Giving generators capacity payments sufficient to stimulate new construction as well as energy prices determined by a single-price auction results in excessive payments for many generators." And, further: "Another example of re-regulation is the creation of an artificial market for capacity – in its latest form the so-called locational installed capacity (LICAP) mechanism."

What is FERC's response to this criticism?

29. Is FERC aware that the ELCON report offers 10 specific recommendations for FERC action to correct the problems it documents in the Organized Markets? Please provide a complete and detailed response to each of these 10 recommendations

30. In the June 2, 2004 LICAP Order, FERC stated that the current NEPOOL Market Rule 1 "created an unjust and unreasonable result."[2] Given that there is currently 28% excess capacity in New England, please explain how low capacity prices can be deemed unreasonable when low prices are a rational economic result of a 28% surplus.

31. In the March 23, 2005 Order, FERC stated that "its preliminary analysis indicated that the overarching concept of the LICAP mechanism proposed by ISO-NE (including the proposal to use ICAP regions and an ICAP demand curve) will, when finalized and implemented, achieve a just and reasonable result"[3] Please make this "preliminary analysis" available to the public for review and comment.

[2] June 2, 2004 Order in Docket ER-03-563-030 at 30.

[3] March 23, 2005 Order in Dockets ER03-563-047 and EL04-102-007